twelfths of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since:

(1) The X Corporation was a shareholder in the Y Corporation on September 30, 1955, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(2) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(3) The X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1956, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends.

It is to be observed that three-twelfths of the undistributed foreign personal holding company income of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1955, the last day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example 3. The X Corporation referred to in example 1 sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, no part of the undistributed foreign personal holding company income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1956, in determining whether the X Corporation is a foreign personal holding company for that year. In such case, the undistributed foreign personal holding company income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1955, which was the last day in the taxable year of the Y Corporation on which the United States group withrespect to the Y Corporation existed. If, however, the X Corporation sells 90percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed foreign personal holding company income allocable to the minority interests of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example 4. If the Y Corporation in example 1 owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undistributed foreign personal holding company income of the Y Corporationwhich is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed foreign personal holding company income. If all three corporations are foreign personal holding companies, the undistributed foreign personal holding company income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain. In the event that after the inclusion of the undistributed foreign personal holding company income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed foreign personal holding company income, would be determined independently of the income of the Y Corporation and the Z Corporation.

§ 1.556–1 Definition.

Undistributed foreign personal holding company income is the amount which is to be included in the gross income of the United States shareholders

under section 551(b) and §1.551–2. Undistributed foreign personal holding company income is the taxable income of the foreign personal holding company, as defined in section 63(a) (computed without regard to subchapter N, chapter 1 of the Code), and adjusted in the manner described in section 556(b) and §1.556–2, less the deduction for dividends paid (§§1.561–1 through 1.565–6). See §1.556–3 for an illustration of the computation of undistributed foreign personal holding company income.

§1.556–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed foreign personal holding company income for any taxable year, there shall be allowed as a deduction the Federal income and excess profits taxes accrued during the taxable year except that no deduction shall be allowed for *(a)* the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), *(b)* the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (c) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the corporation shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the provisions of supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by corporation which deducted taxes paid.* (i) If the corporation was subject to supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, and, for the purpose of computing undistributed supplement P net income under such Code, deducted Federal taxes paid, rather than such taxes accrued, for each taxable year for which it was subject to supplement P of the 1939 Code, the corporation may elect for any taxable year ending after August 16, 1954, to deduct taxes accrued, rather than taxes paid, for the purpose of computing its undistributed foreign personal holding company income. The election shall be made by deducting such taxes accrued in the return (Form 958) required to be filed for such taxable year. The return shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years. See section 6035 and the regulations thereunder for rules relative to the filing of returns of officers, directors, and shareholders of foreign personal holding companies.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after August 16, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In computing taxable income, a foreign personal holding company is allowed a deduction under section 164 for income, war profits, and excess-profits taxes paid or accrued during the taxable year to foreign countries or possessions of the United States, but is not allowed the foreign tax credit under section 901. Therefore, in computing undistributed foreign personal holding company income for any taxable year, no adjustment under section 556(b)(1) is allowed for such taxes.

(b) *Charitable contributions*—(1) *Taxable years beginning before January 1, 1970.* (i) Section 556(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining the undistributed foreign